

**BEFORE THE
POSTAL RATE COMMISSION**

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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 2000

DOCKET NO. R2000-1

**REPLY BRIEF OF
UNITED PARCEL SERVICE**

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United Parcel Service ("UPS") submits this reply brief to respond to a number of arguments made by the United States Postal Service ("the Postal Service") and other parties in their initial briefs. We do not respond to every argument -- we have already dealt with many of them in our initial brief -- but rather discuss only those assertions which seem most likely to mislead the Commission concerning UPS's position or the evidence in the record.

ARGUMENT

**COST COVERAGES FOR THE COMPETITIVE CLASSES
OF MAIL SHOULD BE MAXIMIZED, NOT MINIMIZED.**

Trade associations representing mailers who would benefit from lower rates for Priority Mail and for Parcel Post argue that the cost coverages and rate increases for those competitive services should be reduced. They base their arguments largely on the contention that otherwise the Postal Service would lose volume and market share.

As we have shown in our initial brief, the Commission exists primarily to protect mailers without any readily available alternatives to the Postal Service, not to protect the Postal Service or its market share. Initial Brief of United Parcel Service (“UPS Brief”) at 5-8. Thus, the primary argument of these intervenors is contrary to the statutory ratemaking factors. We show below that their arguments are also contrary to the evidence.

A. Priority Mail Is A Healthy, Growing, And High Value Service Whose Contribution To Institutional Costs Should Be Maximized For The Benefit Of First Class Mail Users, Rather Than Vice Versa.

The Association of Priority Mail Users, Inc. (“APMU”) attacks even the Postal Service’s Priority Mail cost coverage proposal, which would impose a significantly greater share of institutional costs on First Class Mail than on Priority Mail. Initial Brief of the Association of Priority Mail Users, Inc. (“APMU Brief”) at 8-9. It does so despite the fact that the Commission reduced Priority Mail’s cost coverage in the last rate case for reasons that have been shown on this record to be contrary to present realities.

APMU relies on an alleged “continuing deterioration in Priority Mail’s market share,” on assertions by its witness that “Priority Mail’s standard of service was either inferior to, or, at best, equal to that of First-Class Mail,” and on claims that Priority Mail does not stack up well against competitive products. APMU Brief at 9. APMU is wrong on every single point.

To begin with, APMU’s own witness admitted that he knows nothing about the market share statistics on which he relied, and on which APMU now relies. All he could say about those statistics was that it is his “understanding” that they come from The

Colography Group, Inc. ("Colography"). Tr. 25/11730. In fact, data actually produced by Colography under its own letterhead demonstrates that Priority Mail's market share by volume is now higher than it was in 1994, while its market share in terms of revenue has at least held firm. Tr. 45/19625-26.¹

That Priority Mail's market share of revenue is lower than its market share as measured by volume may well be due to the fact that Priority Mail rates **substantially** undercut the rates of its competitors. Table 4 in APMU witness Haldi's testimony (Tr. 25/11529) indicates that the published rates of Priority Mail's competitors are from 250% to 350% of Priority Mail rates. Stated another way, Priority Mail rates are only approximately one-quarter to one-third of its competitors' published rates. Even with a substantial rate increase on the order recommended by Dr. Sappington, Priority Mail rates will remain significantly below those of its competitors. See Tr. 25/11527-31 (citing rate differentials of up to 328% under existing rates and from 94% to 272% under the Postal Service's proposed 15% rate increase).² And for the 25% of Priority Mail volume that is protected by the Private Express statutes, Tr. 25/15108, competitors' rates (including their negotiated rates) will always be at least twice as high as Priority Mail's rates. See 39 C.F.R. § 320.6(c).

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1. The Colography data refers to "shipments." However, Colography has long equated the terms "shipments," "pieces," "volume," and "packages." See, e.g., Docket No. R90-1, Tr. 44/23136, 23142, 23161, 23167, 23171, 23181, and 23187-88.
 2. In the face of these differentials, APMU asserts that competitors' published rates are "very close" to the Postal Service's proposed Priority Mail rates. APMU Brief at 15 (also characterizing the proposed Priority Mail rates as "barely lower" than its competitors' published rates).

APMU's reliance on the rates Federal Express charges one shipper, the United States Government (APMU Brief at 16), is misplaced. No other shipper has such buying power. Moreover, the Priority Mail rates adopted in this proceeding will not go into effect until early next calendar year and will likely remain in effect for a year or two after that. See Tr. 25/11723. Its competitors' rates will likely change at least once and perhaps twice during that period. *Id.* at 11723-24. By then, the Federal Express government rates are likely to have increased as well. In fact, UPS has already had to add a fuel surcharge to the rates shown by Dr. Haldi in his testimony. Tr. 46/19632.

But perhaps the most telling statistic of all is that Priority Mail carries 70% of the volume in the market. Tr. 45/19626. That is well more than twice as much as ***all other competitors combined***. APMU nevertheless apparently complains that Priority Mail's market share is not high enough.

Priority Mail's volume and revenue growth have both been extraordinarily healthy over the past decade, with volume growing at an average annual rate of approximately 10% while revenue has grown at an average annual rate in excess of 12%. Tr. 31/15245. It is no wonder that Colography has touted "Priority Mail's growing influence in the marketplace" and has referred to "the expanding clout of Priority Mail." Tr. 25/11731-32. Even in 1991, when Priority Mail rates increased by 19%, its volume grew by 2.3% while its revenue increased ***by more than 13%***! Tr. 31/15244. Clearly, the way to increase Priority Mail's market share of revenue -- and, more important, the way to increase its contribution to institutional costs -- is by adopting a rate increase that recognizes not only "the dramatic jump in cost-per-piece for Priority Mail" (APMU Brief at 8), but also its superior service characteristics.

APMU attempts to impugn the service provided by the product its members have chosen to use. It continues to argue that "Priority Mail's Service Performance Is Both Worse than that of First-Class Mail, and Deteriorating." APMU Brief at 10. The ODIS service performance statistics on which APMU heavily relies have been shown to be incomplete, outdated -- the 1998 data are for a period when the PMPC network was not fully operational and 1999-2000 data show improvement over 1998 -- and misleading.

As we have shown (UPS Brief at 48-51), the fact that First Class Mail has achieved its far less ambitious two day service standard with somewhat greater regularity than Priority Mail has achieved its much more ambitious two day standard does not mean that First Class Mail gets there **faster** than Priority Mail. More than 90% of all possible ZIP Code pairs are covered by Priority Mail's two day service standard, while less than 20% of all ZIP Code pairs fall within First Class Mail's two day service standard. UPS Brief at 49. Given Priority Mail's vastly more extensive two day service area, APMU's contention is like arguing that a runner who consistently runs the mile in five minutes (First Class Mail) should nevertheless be awarded the Olympic gold medal over a runner who regularly runs the mile in less than four minutes (Priority Mail), just because the faster runner breaks the four minute barrier a little more than 80% of the time instead of every time.

APMU also attempts to impugn the Priority End to End ("PETE") performance data. APMU Brief at 11-12 n.2. Unlike ODIS, PETE service performance data is *independently measured* by PriceWaterhouseCoopers (Tr. 25/11682), like the EXFC data for First Class Mail. Moreover, it is the ODIS data -- not the independently measured PETE data -- that is suspect when it indicates slower performance than

PETE even though ODIS is not an end to end measurement system. The ODIS data is contaminated in that it reflects the First Class Mail service given to unidentified Priority Mail, *i.e.*, in calculating on-time performance for Priority Mail, ODIS actually counts the performance of many pieces that are handled as First Class Mail. Tr. 25/11682-85. Under these circumstances, the fact that the PETE data systematically shows better on-time performance for Priority Mail than does ODIS serves only to highlight that mail moving as Priority Mail does in fact get faster delivery than mail which is handled as part of the First Class mailstream.

The proper remedy for the "unidentified Priority Mail" problem is to require Postal Service employees and mailers to clearly mark all Priority Mail as such, not to reduce Priority Mail's cost coverage. In any event, even as measured by ODIS there is little doubt that while Priority Mail may not meet its far more demanding service standard quite as frequently as First Class Mail meets its far less demanding standard, Priority Mail nevertheless usually gets there faster. That is particularly impressive given that Priority Mail consists almost exclusively of harder to handle flats and parcels while First Class Mail carries mainly letter mail. Tr. 31/15250 n.32. As we have shown, when First Class Mail's service performance is compared to Priority Mail's performance for items of the same type, Priority Mail is the winner. UPS Brief at 49, citing Tr. 31/15251 n.34, 15320-21.

APMU's claim that Priority Mail's cost coverage should be depressed below that of First Class Mail even further than the Postal Service has proposed because Priority Mail does not offer all of the service features offered by its competitors also tells only half the story. APMU Brief at 12-15. The record shows that from the standpoint of one

of the most important service features of any delivery product -- when the addressee receives the item sent -- Priority Mail offers something that its competitors do not. Priority Mail is delivered every Saturday at no extra charge -- a service that is highly desirable in the case of the many businesses that receive mail on Saturdays, Tr. 31/15368 -- and it is even delivered on Sundays during the peak season. *Id.*³ Sunday delivery is never provided by Priority Mail's competitors, and Saturday delivery, when it is offered at all, is offered only at a hefty additional charge. Tr. 25/11719-21.⁴

Again, however, perhaps the best indication that Priority Mail offers those service features which are important to shippers is its overwhelming market share (see pages 2-4, *supra*). Clearly, APMU's assertions about Priority Mail's "competitive disadvantage" (APMU Brief at 12-14) are overstated.

APMU's warnings about the dangers of extrapolating the effect of Dr. Sappington's recommended rate increase from Dr. Musgrave's Priority Mail elasticity (APMU Brief at 31-32; Tr. 45/19604-05) are unsubstantiated and speculative. APMU fails to point out that Dr. Musgrave's testimony provides the best available information about the likely effects of Priority Mail rate increases. Indeed, the evidence indicates that Dr. Musgrave's estimates are more likely to understate than to overstate Priority Mail volumes: actual Priority Mail revenues and volumes have exceeded its projected

3. Approximately 55% of Priority Mail is sent from businesses to businesses; 91% of Priority Mail is either sent to or by businesses. Tr. 9/3566-67.

4. Large shippers such as the members of APMU also receive delivery confirmation service at no additional charge. APMU Brief at 2. Smaller Priority Mail shippers and single piece users must pay extra for delivery confirmation, in addition to underwriting the free provision of that service to large users.

revenues and volumes by substantial amounts in recent years, including in the Docket No. R90-1 test year, when Priority Mail rates were increased by 19%. Tr. 25/11710-14. The trend of Priority Mail outperforming projections is continuing in FY2000. Tr. 35/16845-46.

APMU trots out the parable of Express Mail to warn that the Priority Mail sky is falling. APMU Brief at 16-17. But Priority Mail is not showing any evidence of imminent demise. Rather, as we have shown, it is an extremely healthy product offering. To require it to pay its attributable costs plus a portion of institutional costs that is commensurate with its high value of service would certainly not be to "kill the goose that lays the golden eggs," as APMU's witness speculates. Tr. 25/11517. Instead, as Dr. Sappington has shown, his recommendation would increase, not decrease, Priority Mail's contribution to institutional costs. Tr. 31/15326. Thus, APMU's approach amounts to asking a very healthy golden goose to lay fewer golden eggs and instead shift the resulting extra burden onto the usual workhorse, First Class Mail users.

Finally, APMU implies that the costs of the Emery contract should be ignored because the Emery contract will likely be terminated. APMU Brief at 21. But the recent decision of the Court of Federal Claims denies Emery the right to terminate that contract. *Emery Worldwide Airlines, Inc. v. United States*, Docket No. 00-173C, United States Court of Federal Claims, decision filed August 25, 2000, Slip Opinion at 25-26. And even if the parties mutually agree to terminate that contract, the Postal Service may very well end up spending **more** to replace Emery or to do the job itself.

* * *

As APMU itself notes (APMU Brief at 9), in Docket No. R97-1 the Commission departed from the historical relationship it had always adopted, without exception, under which Priority Mail's cost coverage was uniformly higher than that for First Class Mail. The record in this case establishes that it is time to begin to restore that historical relationship, in order to provide the protection of monopoly First Class Mail users that Congress intended.

The rate increase proposed by Dr. Sappington moderates Priority Mail's cost coverage in light of the increase in its attributable costs by producing a markup ratio equal to that of First Class Mail when the markup ratio should actually be higher. Tr. 31/15258-59.⁵ Dr. Sappington's cost coverage will result in *increasing*, not decreasing, Priority Mail's contribution to institutional costs, Tr. 38/17249, to the benefit of all other users, especially First Class Mail users, who will inevitably pay the lion's share of any institutional costs that are shifted away from Priority Mail. See Tr. 30/14742 ("Protecting monopoly customers would require that the Postal Service move toward increasing the contribution from competitive classes such as ECR").

Dr. Sappington has conducted a thorough analysis of (1) the statutory ratemaking factors as they apply to the evidence in the record and (2) the "pluses" and "minuses" of his proposed cost coverage and the resulting rate increase. While the rate increase is high, his recommendation represents a balanced consideration of all of the ratemaking factors. In the absence of a substantial increase, Priority Mail's cost

5. The Postal Service is therefore wrong when it states that "Mr. Sappington exempts the current situation from the implications of his advice on mitigation." Postal Service Brief at VII-96.

coverage will continue on a downward spiral, to the detriment of the Postal Service's captive customers. Accordingly, the Commission should adopt Dr. Sappington's recommendation.

B. It Is Time For Parcel Post To Begin To Shoulder A Meaningful Portion Of The Institutional Cost Burden.

The Parcel Shippers Association ("PSA") argues that even the miniscule 1.3% Parcel Post rate increase proposed by the Postal Service is excessive. Initial Brief of Parcel Shippers Association ("PSA Brief") at 5-6.⁶ In particular, PSA argues that Parcel Post's cost coverage should remain at a depressed level (109%), PSA Brief at 7, where it has been since Docket No. R94-1.

The Commission's reduction of Parcel Post's cost coverage in Docket No. R94-1 from the 111% coverage recommended in the prior case -- a coverage that is significantly lower than that for the Postal Service's deferred Standard Mail (A) service (133%) -- was based primarily on a concern over a perceived decline in Parcel Post volumes. R94 Decision at V-113 to V-115, ¶¶ 5345-5350. The figures before the Commission in the next case, Docket No. R97-1, indicated that in the immediately prior two years, Parcel Post volume had declined by 2.7% (in 1995) and by 2.3% (in 1996). Tr. 31/15262. However, regardless of whether the DRPW-only or the hybrid

6. PSA argues that the Postal Service's proposed rate increase is 2.3%, not 1.3%. PSA Brief at 7-8. Assuming PSA is correct, the proposed Parcel Post rate increase would still be significantly less than half of the systemwide average rate increase of 6.5%. USPS-T-32 at 36. That fact alone indicates that Parcel Post, with its minimal cost coverage, is not bearing its fair share of the revenue increase requested by the Postal Service in this case.

BRPW/DRPW volume estimates are adopted (a subject we discuss at pages 18-28, *infra*), "Parcel Post volume and revenue have grown substantially in recent years." Tr. 31/15262. Indeed, 1995 and 1996 seem to be aberrations in an otherwise extraordinary decade-long performance by Parcel Post, which has seen volume increases of almost 20% (in 1992 and 1994) and generally in excess of 11% (1993, 1997, and 1998). *Id.*

PSA's suggestion that the Postal Service's revised, vastly increased Parcel Post volume and revenue estimates somehow show that Parcel Post's rates should stay at their current levels (PSA Brief at 1, 7) is based on contorted logic. PSA assumes that when the Commission recommended a cost coverage of 108% for Parcel Post in Docket No. R97-1, the Commission was not influenced in any way by Parcel Post's then-recent (1995 and 1996) volume and revenue performance. However, if the Commission had believed that Parcel Post's volumes and revenues were substantially higher than the data in that case indicated, the Commission may well have established a higher cost coverage for Parcel Post. PSA's guess that the Commission "would have recommended a rate increase for Parcel Post no greater than the system-wide average increase" (PSA Brief at 1) in Docket No. R97-1 if the Postal Service's current estimates had been available is speculative at best, and actually cuts against a major reason the Commission gave for reducing Parcel Post's cost coverage in Docket No. R94-1.

Even under the DRPW-only approach Parcel Post's volume increased by almost 13% in 1998 while its revenue increased by almost 7%. Tr. 31/15262-63, 15355. That is a far cry from the declines before the Commission in Docket No. R97-1. Just as

important, Parcel Post's value of service has increased since Docket No. R97-1. Thus, its volume is likely to continue to grow.

PSA, like APMU, relies heavily on the argument that the Postal Service's market share is lower than it should be. PSA Brief at 9-11. It does so by comparing apples and oranges. It insists that the vast numbers of packages which the Postal Service carries in the Standard Mail (B) subclasses other than Parcel Post and in Standard Mail (A) do not count, even though it acknowledges that these are part of "the various volumes of ground transportation." PSA Brief at 9. Those services can possibly fit only in the "deferred or ground transportation service" market defined by PSA itself. PSA Brief at 10. Even using the market definitions of PSA's own witness, the Postal Service has a substantial share of the market (UPS Brief at 61) -- undoubtedly because it has separate, extraordinarily low rates for "non-Parcel Post" parcels.

Most important, however, expansion or protection of the Postal Service's market share is not one of the statutory ratemaking factors. See 39 U.S.C. § 3622(b); Tr. 25/11728-29. In fact, it is contrary to the statute. See UPS Brief at 5-8. See also Tr. 30/14982, 14987-88 (NAA witness Tye). PSA's claim that "Any increase in Parcel Post rates will . . . damage competition" (PSA Brief at 2) serves only to protect a particular competitor -- the Postal Service -- and is therefore contrary to PSA's own proposition that the statute is intended to protect competition, not particular competitors. *Id.* at 11.

As Dr. Sappington pointed out in his testimony (Tr. 31/15238-39), attributable costs as currently estimated by the Commission likely understate incremental costs, the universally acknowledged test of whether cross-subsidy exists. See Tr. 31/15233-39. As a result, "modest markups . . . can permit revenue to fall below incremental cost, and

thereby lead to cross subsidies." Tr. 31/15238. If Parcel Post is given a minimal cost coverage, there is a serious risk that Parcel Post rates will be below cost almost from the very first day that the rates adopted in this proceeding go into effect.

Amazon.com claims that "witness Sappington actually does not know whether Parcel Post revenues have in fact covered attributable costs" in "1989-91, 1993-94, and 1996-98." Initial Brief of Amazon.com, Inc. ("Amazon Brief") at 30. It states that Dr. Sappington's "calculations do not reflect the Commission's Alaska Air adjustment to Parcel Post's attributable costs." *Id.*

However, for the two years in which the Postal Service has reported costs using the Commission's methodology (including the Alaska Air adjustment) -- 1997 and 1998 -- Parcel Post was unquestionably below cost under the established Parcel Post volume and revenue estimation approach. Tr. 31/15350. In addition, the Alaska Air adjustment is not the only adjustment to Postal Service costing methods that must be made in order to estimate attributable costs under the Commission's approach. In the years prior to 1997 other adjustments that tend to increase the costs attributable to Parcel Post (such as attributing 100% of mail processing labor costs) must also be made. The relevant question is whether Parcel Post's revenues fell below attributable costs when *all* relevant changes, not just the Alaska Air adjustment, are made.

The evidence indicates that when all such adjustments are made, Parcel Post rates have been below attributable costs for much of the past decade. In 1997 Parcel Post's attributable costs as measured by the Postal Service were less than 2% higher than attributable costs as measured under the Commission's approved methods. The corresponding difference in 1998 was approximately 3%. Even if Parcel Post's

attributable costs as measured by the Postal Service's costing methods were reduced by 3% in every year between 1989 and 1996, Parcel Post revenues would still fall below these reduced attributable costs in all of those years except 1992 and 1995 (as Dr. Sappington testified, Tr. 31/15264). And this fails to take into account the fact that Parcel Post's attributable costs as estimated by the Commission are almost certainly lower than its incremental costs.

In short, Dr. Sappington's observations about a systematic and ongoing cross-subsidy of Parcel Post are valid. The Postal Service's proposal of a 1.3% rate increase for Parcel Post in this case apparently represents a continuation of a strategy of cross-subsidizing Parcel Post at the expense of First Class Mail users in order to obtain increased volume. Tr. 30/14711 ("The rate proposals conform to a pattern of an enterprise seeking to use rate levels and rate design to shift volume from private enterprise competitors and to finance these rate structures with revenues from mail legally protected from competition").

Amazon.com takes issue with Dr. Sappington's testimony that the new "Parcel Select" rate categories have increased Parcel Post's value of service. It notes that "the DDU-entry Parcel Post element should be examined in context, *rather than as an artificially distinct service.*" Amazon Brief at 31 (emphasis added). But that is precisely the approach that Dr. Sappington took. As he explained, the new DSCF and DDU rate categories have enabled Parcel Post to become "an *integral component* of a service that provides high value to both the senders and the recipients of parcels." Tr. 31/15265-66 (emphasis added).

Dr. Sappington's testimony that Parcel Post's value of service has increased since Docket No. R97-1 relies on factors such as improved delivery times (see Tr. 31/15265) as well as on the availability of the new DSCF and DDU dropshipment categories. The improvement in Parcel Post's delivery times started in 1995 (see *id.*), well before the DSCF and DDU dropshipment categories were implemented in 1999. The implementation of those services will undoubtedly serve to further improve Parcel Post's delivery performance.

Amazon.com's discussion of Parcel Post's "incremental" value of service (Amazon Brief at 32-33) is similarly deficient. First, Dr. Sappington explained the danger of relying too heavily on the concept of incremental service value. Tr. 31/15423-26. Second, Amazon.com's suggestion that the Commission should not increase Parcel Post's cost coverage merely because it does not have perfect information on Parcel Post's competitors -- a suggestion that is a sure-fire recipe for inaction -- misses the point. Amazon Brief at 33. The Commission is seldom fortunate enough to have perfect information on any issue. It must therefore rely on the best information it has on all of the issues it must decide, including decisions concerning appropriate cost coverages. The best available evidence in this record indicates that whatever the level of Parcel Post's value of service as compared to that of its competitors, the value that Parcel Post gives to its users has *increased* since Docket No. R97-1 as compared to the level of service Parcel Post then provided.

The Postal Service misstates Dr. Sappington's testimony when it argues that "Dr. Sappington recanted from the view that own price elasticity of demand does not merit consideration in assessing value of service." Initial Brief of the United States Postal

Service ("Postal Service Brief") at VII-28 (citing Tr. 31/15580-87) (footnote omitted).

First, Dr. Sappington did not testify that own-price elasticity "does not merit consideration" as a measure of value of service. Rather, the very first sentence of his testimony on the "Inappropriate Use of the Own-Price Elasticity" warns against "Undue reliance" on own-price elasticities as measures of service value. Tr. 31/15229.

More important, the Postal Service's apparent desire to emphasize elasticity measures to determine value (rather than to project volumes or to test for the availability of alternatives) serves as a convenient excuse to raise rates for captive customers who have few or no alternatives to the Postal Service in order to minimize the rates for competitive services, where mailers do have alternatives. That is precisely one of the dangers warned against by Dr. Sappington. Tr. 31/15230-32.

If the own-price elasticity of a product is used as the primary measure of service value, one is almost invariably led to conclude that competitive postal products provide low value of service while monopoly products provide high value of service. This conclusion is not necessarily true. The volume of a service may decline rapidly as its price increases even though its users highly value the service. Tr. 31/15230. More importantly, using own-price elasticity as a major measure of service value runs counter to both the letter and the spirit of the Postal Reorganization Act by leading to higher rates for monopoly products and lower rates for competitive products.

The Postal Service seems to concede that it is inappropriate to systematically link high own-price elasticities with low value of service. See Postal Service Brief at VI-28 n.25. Nevertheless, it appears to rely on precisely this systematic linkage when it discusses Priority Mail's value of service. Specifically, it states that Priority Mail's "price

elasticity is considerably higher than that of First-Class Mail, indicating a lower value of service.” Postal Service Brief at VI-15. The discrepancy between what the Postal Service practices and what it preaches underscores the importance of the cautions that Dr. Sappington offers in his testimony.

Finally, Dr. Sappington did not “utterly fail[]” to consider own-price elasticities of demand in arriving at his recommendations, as the Postal Service claims. Postal Service Brief at VI-29. Instead, he made abundantly clear that a service’s own-price elasticity of demand should not be ignored. Tr. 31/15423-26. If nothing else, his examination of Parcel Post’s volume history reflects the results of own-price elasticities.

That Parcel Post’s value of service has improved since Docket No. R97-1 is evident from its volume and revenue growth, the newly-available Delivery Confirmation service, the increased ability of mailers to use consolidators to achieve higher service levels at rates lower than those previously available, and Parcel Post’s overall improved delivery times. Tr. 31/15265-66. Whatever the absolute level of Parcel Post’s service (see PSA Brief at 8), the fact of the matter is that it is now higher than it was in Docket No. R97-1. As a result, a higher cost coverage is appropriate.

* * *

It does not take too much to justify the small increase in Parcel Post’s cost coverage proposed by Dr. Sappington, especially in view of Parcel Post’s minimal cost coverage. Dr. Sappington’s recommended coverage would merely return Parcel Post to the level adopted by the Commission in Docket No. R90-1. The Commission should

take the small step recommended by him on the road to having Parcel Post shoulder a more meaningful share of the Postal Service's institutional costs.

**THE POSTAL SERVICE AND PSA HAVE FAILED TO
REHABILITATE THE SUSPECT BRPW/DRPW PARCEL
POST VOLUME AND REVENUE ESTIMATES.**

At least in its opening brief, the Postal Service has mounted what is at best a weak defense of its hybrid BRPW/DRPW Parcel Post volume and revenue estimates. Postal Service Brief at III-13 to III-14.⁷ Instead, PSA has rushed to the defense of the Postal Service's ill-considered effort to reject the results of a still-used Postal Service sampling system that has been relied on since at least 1970 to estimate Parcel Post volumes and revenues, in favor of a hastily-adopted patchwork "methodology" that was put together before the Postal Service could investigate it sufficiently, or before it could put into place checks on the accuracy of the new approach.

PSA states that the hybrid approach "avoids the types of data collection errors that infect DRPW." PSA Brief at 12. There is absolutely no evidence whatever that DRPW is "infected" with data collection errors. On the contrary, the Postal Service did not come forward with one single example of an erroneous Parcel Post DRPW data sample. Instead, it came forward on rebuttal with only the speculative musings of unidentified individuals that its DRPW data collectors do not know what they are doing (at least in the case of Parcel Post, and perhaps Bound Printed Matter and Standard Mail (A) as well, see Tr. 43/18793), with not one iota of hard evidence to support those

7. Presumably, the Postal Service is saving its ammunition for its reply brief, when there will be no opportunity to rebut its arguments.

musings. Indeed, it defended the training given to its DRPW data collectors when the Commission posed questions on that subject. Tr. 46/21547.

PSA argues that only a few records in the BRPW data fail BRPW's revenue tolerance test. PSA Brief at 13. That few records fail is not surprising. Given the broad nature of the test, it is surprising that any records fail.

As Mr. Sellick testified (Tr. 31/15039-42), the revenue tolerance test only checks to see whether the average revenue per piece for the rate category (*i.e.*, the postage paid per piece) is no more than 5% higher than the highest possible rate for the zone involved and no lower than 5% lower than the lowest possible rate for that zone. Tr. 31/15040-41. In other words, a record passes the test as long as the postage paid is no more than 5% lower than the two pound rate in a zone and no more than 5% higher than the rate for a 70 pound parcel in the zone, even though the recorded postage may bear no relationship to the rate that should actually have been or actually was paid. For example, a record would pass the revenue tolerance test even though the PERMIT System data entry operator mistakenly entered information indicating that a shipment contained 45 ten pound parcels sent to zone 5 when in fact the shipment actually contained only 25 ten pound parcels going to zone 5.⁸ Since the PERMIT System/BRPW approach does not record weight correctly, real error rates cannot be accurately determined. Tr. 31/15041-42.

8. This example merely illustrates the operation of the test. Examples with larger discrepancies between the number of pieces actually mailed as opposed to the number of pieces entered by the data entry operator could also be constructed.

PSA also argues that the results of the Parcel Post trial balance adjustment for postal quarters 3 and 4 of FY1999 show that the hybrid estimate is more accurate than the DRPW-only estimate. PSA Brief at 15. It states that “no party has provided any evidence that the trial balance adjustment factors for PQ 3 and 4 are unrepresentative of those for PQ 1 and 2.” PSA Brief at 15 n.3. Not only does this reverse the burden of proof -- the Postal Service has the burden of demonstrating that the revenue and volume estimates generated by its newly proposed method should replace those produced by a well-established method that has long been relied on by the Commission, *see* 5 U.S.C. § 556(d) -- but it is clearly wrong.

Where they have been used, trial balance adjustment factors have differed from quarter to quarter, sometimes resulting in increases in estimated revenues and sometimes resulting in decreases in estimated revenues. Tr. 46/20979-80. Merely because the Parcel Post trial balance adjustment resulted in increasing the revenue estimate in two quarters of 1999 does not mean that it would also result in an increased estimate for the other quarters in 1999. Nor does it say anything at all about what the adjustment would have been in 1998. In fact, the FY1998 overall Book Revenue Adjustment Factors -- which were not applied to the BRPW portion of the hybrid Parcel Post estimate -- averaged approximately .94, indicating a 6% *overestimate* of revenues (*i.e.*, requiring a downward adjustment to revenues of approximately 6%). Tr. 31/15038-39. It would be particularly inappropriate to read too much into the trial balance adjustment factors for postal quarters 3 and 4 in FY1999, since those quarters do not include the peak holiday mailing season (Tr. 41/18091), which straddles postal quarters 1 and 2.

PSA asserts that “only a very small proportion of bulk Standard (B) Parcel Post parcels in FY 1998 weighed less than one pound” PSA Brief at 16. It relies on the testimony of its witness concerning conversations he had with “several” parcel shippers about whether they mailed parcels weighing less than one pound at the Parcel Post rates in FY1998. Tr. 41/18064 n.4. But there was no indication of how many shippers Mr. Glick talked to, or whether they are representative of shippers of Standard Mail (A) and Standard Mail (B) parcels in general. Mr. Glick’s testimony merely illustrates that it is in fact the case that some unknown portion of Standard Mail (A) parcels and their associated revenues were improperly counted as Parcel Post volume and revenue in FY1998 and in FY1999.

PSA again makes an illogical leap when it asserts that elimination of the Standard Mail (A) Single Piece subclass on January 10, 1999, “avoid[s] this potential issue altogether.” PSA Brief at 17.⁹ Quite the reverse is true: the elimination of the Standard Mail (A) Single Piece subclass means that mailers sending parcels that weigh less than one pound but that do not qualify for the remaining bulk Standard Mail (A) categories (because of insufficient volume, for example) must be entered as mail of some other class, be it First Class Mail or Priority Mail -- either of which would be a

9. PSA cites an interrogatory response by UPS witness Sellick in support of this statement. In fact, the interrogatory response supports only that part of the statement indicating that the Standard Mail (A) Single Piece subclass was eliminated in January of 1999; it does not in any way support the statement that the elimination of that subclass “avoid[s] this potential issue altogether.” See Tr. 46/20654-56.

correct classification -- or Parcel Post, which would be an incorrect classification that inflates the volume and revenue estimates for Parcel Post.¹⁰

PSA makes still another unsupported leap of logic when it relies on Mr. Prescott's unsupported testimony that "the costs of [under one pound pieces recorded as Parcel Post] mail are also properly accounted for as Standard Mail (B)." PSA Brief at 17, citing Tr. 43/18804. There is absolutely no basis -- none whatever -- to support a conclusion that the Postal Service's costing systems, either in FY1998 or in FY1999, recorded under one pound pieces as Parcel Post. On the contrary, Postal Service Handbook F-45 concerning the In-Office Cost System ("IOCS") specifically states that to be counted as Parcel Post, a piece must weigh more than 16 ounces. Library Reference USPS-LR-I-14, Handbook F-45, "In-Office Cost System Field Operating Instructions," June 1998, at 13-10 (in evidence at Tr. 21/9289).

Even if it were the case that the costs associated with these parcels were recorded, along with their volumes and revenues, as part of Parcel Post, that does not mean that the Commission should overlook this obvious defect in the BRPW revenue, pieces, and weight data. It merely means that the cost data for Parcel Post is misstated as well, since, as we have shown in our initial brief, the cost of handling parcels that

10. PSA's implicit assumption that mailers who had been accustomed to sending Standard Mail (A) Single Piece parcels as Parcel Post would have immediately ceased doing so on January 10, 1999, is unrealistic. Mailer practices often change slowly even in the face of changes in mailing requirements, as shown by mailers' continued use in FY1998 of outdated forms going as far back as February 1991. See Tr. 41/18109-11.

weigh less than one pound is substantially less than the cost of handling Parcel Post pieces. UPS Brief at 91.

The FY1999 data produced by the Postal Service contained, according to Postal Service witness Degen, IOCS tallies where the data collector erroneously recorded Standard Mail (A) pieces as Special Standard Mail (B). Tr. 45/20052-54. It is at least as likely that pieces bearing an ambiguous Standard Mail (A) endorsement were incorrectly identified as Parcel Post by bulk mail entry unit personnel. Bound Printed Matter pieces and Special Standard Mail (B) pieces lacking the proper endorsement were almost certainly counted as Parcel Post: in the case of pieces weighing 16 ounces or more, the Postal Service's instructions to data collectors apparently are to count the piece as Parcel Post if the endorsement does not clearly indicate the class of mail to which the piece belongs. See USPS-LR-I-37, Handbook F-75, "Data Collection User's Guide for Revenue, Volume, and Performance Measurement Systems," September 1997, at 3-214 (in evidence at Tr. 7/3134) (indicating that "With one exception, always record unendorsed mail weighing 16 ounces or greater as Standard Mail (B) zone rated parcel mail. The one exception to this rule is when the mailpiece bears metered or stamped postage equal to or greater than what the mailpiece's Priority rate would be if you were to base this rate upon the mailpiece's zone and weight.").

PSA makes another sweeping but unsupported statement on page 18 of its brief when it states that "Mr. Sellick's analysis of Forms 8125 showed" that BRPW's incorrect recording of Standard Mail (A) parcels as Parcel Post had not "caused major problems in BRPW." The Postal Service produced only a limited number of Forms 8125

(approximately 500 out of a universe that is far greater); it produced virtually no postage statements at all. Mr. Sellick (and counsel for UPS on cross-examination of Mr. Glick) pointed to a limited number of specific examples illustrating deficiencies in the forms solely to show that these concerns were real and not just speculation. A review of all of the forms in Library Reference USPS-LR-I-314 shows that many more examples could be provided.

Unfortunately, the Postal Service repeatedly objected to requests to produce more information (a random sample of postage statements, additional financial audit reports, postage statements underlying three particularly large BRPW records, etc.) that may have permitted the extent of these problems to be quantified. As a result, the evidence shows that based on the limited information which was made available, there are substantial reasons to be concerned about the accuracy of postage statement data as well as about the accuracy of the PERMIT System data base in light of erroneous data entry.

PSA argues that the Postal Service has come forward with a "reasonable explanation" of the discrepancy between the DRPW-only estimate and the hybrid BRPW/DRPW estimates which suggests that the DRPW-only estimates are wrong. PSA Brief at 19-21. That just is not the case. The rebuttal testimony of Postal Service witness Prescott which PSA extensively quotes on this point is, as we have already pointed out, speculative at best. There is absolutely no indication that "some DRPW data collectors were considering all Standard Mail (B) permit imprint mail to be ineligible for sampling." Tr. 43/18793, quoted at page 20 of PSA's Brief. There is only conjecture that this *may* have happened.

That stands in stark contrast to the hard evidence that the BRPW system was incorrectly recording an unknown portion of Standard Mail (A) pieces as Parcel Post. The most that Mr. Prescott's testimony shows is that there may be widespread confusion in the Postal Service between Parcel Post on the one hand and Bound Printed Matter on the other, and also between Parcel Post as opposed to Standard Mail (A). It is just as likely -- if not more likely -- that Postal Service bulk mail entry personnel have incorrectly classified Bound Printed Matter pieces as Parcel Post, for example.

Curiously, Mr. Prescott stated that "Possible reasons" for the alleged DRPW-only undercount included "not sampling any PERMIT imprint Parcel Post . . . weighing less than a pound; this mail could be *misidentified as Standard Mail (A)* and would be viewed as ineligible for sampling." Tr. 43/18793 (emphasis added). Of course, as we have shown (UPS Brief at 68-70), "PERMIT imprint Parcel Post . . . weighing less than a pound" is not Parcel Post at all, but rather is **correctly** identified as Standard Mail (A). Mr. Prescott's reasoning is not only flawed, but it is contrary to the requirements of the Commission-recommended and Governors-approved *Domestic Mail Classification Schedule*. See UPS Brief at 68-69.

PSA attempts to turn around Mr. Sellick's testimony showing that the estimate of 261 million Parcel Post pieces generated by the Postal Service's own data on the volume of Parcel Post handled by city delivery and rural carriers and on Special Purpose Routes corroborates the DRPW-only estimate of 266.5 million pieces. Tr. 37/16959. Contrary to PSA's suggestion (PSA Brief at 21), Mr. Sellick specifically recognized that the city carrier/rural carrier/Special Purpose Routes estimate of 261 million pieces does not take into account Parcel Post pieces delivered through firm

holdouts, box sections, and window service recipients. Tr. 37/16979. That is why it is lower than the DRPW-only estimate. As Mr. Sellick testified on cross-examination, one would have to believe that 55 million Parcel Post pieces, or more than 17% of total Parcel Post volume as measured by the Postal Service's hybrid method, were delivered through these means to believe the Postal Service's hybrid estimate. Tr. 37/16979, 16983-85. That is highly unlikely.

The Postal Service states that "accurate postage statements are in the best interest of both mailers and the Postal Service." Postal Service Brief at III-11. The Postal Service misses the point. Postage statements may contain inadvertent errors, especially when Postal Service bulk mail entry unit personnel make little or no effort to check their accuracy. See, e.g., Tr. 31/15111-16. More important, in entering information into the PERMIT System database Postal Service data entry operators may make data entry errors that misstate the information on perfectly accurate postage statements -- such as erroneously entering Bound Printed Matter pieces and revenue as Parcel Post volume and revenue.¹¹ And unfortunately, mailers may sometimes give in to the temptation to provide inaccurate postage statements that, for example, include Priority Mail pieces as part of a larger shipment of Parcel Post and record them as Parcel Post on the postage statement. The Postal Service itself recognizes that in the absence of a trial balance adjustment, revenue estimates may be overstated due to

11. Until January 10, 1999, postage statement Form 3605-R covered both Bound Printed Matter and Parcel Post as well as Priority Mail. Tr. 31/15024, 15050-51, 41/18116-17. It is likely that mailers continue to use that form today. See Tr. 41/18109-10.

overpayments of postage. See Tr. 46/21025 n.4. See *also* USPS-LR-I-323 at 219 (in evidence at Tr. 31/15127) (audit report referring to "two double postings of the same postage statements resulting in an overcharge of [redacted] in postage").

Finally, the Postal Service argues that ODIS data on permit imprint Parcel Post "aligns well" with the hybrid BRPW/DRPW estimate. Tr. 43/18793. It did not provide any data to support that assertion. The ODIS data for FY1998 on **total** Parcel Post volume that is in the record seems to suggest either that the DRPW-only estimate is correct, or that even the Postal Service's hybrid BRPW/DRPW estimate vastly *understates* total Parcel Post volume. In particular, data taken from ODIS Table 7 for "Standard B" mail, which appears to equate to Parcel Post,¹² suggests a total Parcel Post volume of 233 million pieces for PFY1998.¹³ On the other hand, volume data from ODIS Table 4 suggests a total Parcel Post volume of 402 million pieces in FY1998. In short, the evidence in the record suggests that ODIS data on **total** Parcel Post volume either "aligns well" with the DRPW-only estimate, or does not align well at all with either the DRPW-only or the hybrid estimate.

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12. According to the "Contents" pages to the ODIS reports, Table 7 is entitled "Percentage of Parcel Post and Other Standard B Mail Delivered Within Specified Number of Days By Administrative Control." See, *e.g.*, USPS-LR-I-170, Origin-Destination Information System Quarterly Report Postal Quarter I, PFY1998 (in evidence at Tr. 21/19376). See *also id.* at 10.
 13. This figure is obtained by multiplying the average daily volume for each quarter contained in USPS-LR-I-170 by the number of days in the quarter, and then adding the totals for all four quarters.

The evidence shows that the Postal Service's adoption of the hybrid BRPW/DRPW Parcel Post estimates was hasty and ill-considered. In the absence of a more thorough review than has been permitted in this proceeding, such a drastic change from the long-established DRPW-only method of estimating Parcel Post revenue, pieces, and weight should be rejected in favor of the DRPW-only approach.

**THE MISLEADING ARGUMENTS MADE ON BRIEF
CANNOT CURE THE DEFICIENCIES IN THE POSTAL
SERVICE'S MAIL PROCESSING ANALYSIS.**

The Postal Service's position that attributable mail processing labor costs should be reduced is based almost exclusively on a set of complex equations that measure the wrong thing. In particular, like the Postal Service's previous analysis in Docket No. R97-1, Dr. Bozzo's mail processing presentation (1) is too short run in nature and fails to capture the full effect of numerous types of Postal Service decisions concerning how to handle increased volumes, and (2) seeks to measure the relationship between piece handlings ("workload") and hours rather than the impact of volume on costs. The arguments made on brief cannot overcome these and other shortcomings of the analysis, which are presented in more detail in our opening brief (UPS Brief at 14-26) and in the comprehensive testimony presented by UPS witness Neels. Tr. 27/12770-885, 46/22267-98.

The Postal Service begins its argument by stating that Postal Service rebuttal witness Greene "presented evidence on volume variability." Postal Service Brief at V-11. That is not so. Dr. Greene's testimony was limited to commenting on certain fine points of econometric analysis. In fact, Dr. Greene himself repeatedly stated that he

was not familiar enough with the Postal Service and its operations to shed any light on the volume variability of mail processing costs. See, e.g., Tr. 46/22052, 22097.

The Postal Service then argues that a qualitative analysis of mail processing operations demonstrates that mail processing costs are not fully volume variable. Postal Service Brief at V-11 to V-13. However, many of the factors it cites as affecting mail processing costs are in turn affected by volume. The Postal Service's failure to recognize this is one of the more serious shortcomings in its analysis. Indeed, almost all of the factors listed on page V-12 of its brief are within the control of the Postal Service, and the way in which the Postal Service deals with them is affected by mail volume.

The Postal Service's argument that additional volume at the peak may increase staffing at the peak but has no effect on "workhours at the 'shoulder'" (Postal Service Brief at V-15 to V-16) also misses the mark. The mere fact that excess capacity exists in the "shoulders" demonstrates that staffing during off-peak times is dictated by the volume handled at the peak; otherwise, the Postal Service would adjust staffing in the shoulders so as to avoid any excess capacity. In other words, increases in peak volumes tend to increase off-peak staffing, and the amount of excess capacity that exists in the shoulders of the peak is dictated by the amount of volumes during the peak. In the absence of data demonstrating otherwise, logic and common sense establish that volume growth occurs both during peak volume periods and during off-peak periods, and that off-peak costs respond both to off-peak volume growth and to growth in volume at the peak.

The Postal Service relies on the testimony of intervenor witness Stralberg. See, e.g., Postal Service Brief at V-18 to V-21. However, in his original testimony Mr. Stralberg provided examples which illustrate perfectly how peak volumes determine staffing levels. See, e.g., Tr. 24/11374-76. In any event, the Postal Service's "micro-analysis" does not deal with the central issue. The overriding question concerns the variability of **total costs** with respect to **total volume**. As Dr. Neels testified (Tr. 27/12795), the Postal Service's MODS cost pool-level approach ignores the interrelationships among cost pools -- interrelationships which Mr. Stralberg vigorously argues exist, Tr. 38/17286-87 -- and thus that analysis cannot capture the full effect of volume on costs.

The Postal Service also states (Postal Service Brief at V-17) that mail processing costs are not fully volume variable because the Postal Service can handle volume increases by adjusting "worker pacing" rather than by incurring additional labor costs. But why is it that the Postal Service is able to "capture [workers'] discretionary effort" (Postal Service Brief at V-17, quoting Tr. 38/17320) only as volume grows, but not in dealing with its baseline volumes?

In any event, the Postal Service misunderstands Dr. Neels' testimony commenting on Mr. Degen's operational analysis. Dr. Neels was not attempting in that discussion to demonstrate that volume variability must be 100%. Rather, he was indicating that Mr. Degen's analysis does not establish that mail processing labor costs cannot possibly be fully volume variable.

The Postal Service argues (Brief at V-21) that "No reliable statistical evidence has ever supported the 100 percent volume-variability assumption for mail processing."

That is just not so. Despite the Postal Service's oft-repeated refrain that Dr. Neels' own analyses find volume variability to be less than 100%, see, e.g., Postal Service Brief at V-23 to V-26, Dr. Neels has presented econometric results which support the Commission's long-held conclusion that mail processing labor costs are essentially fully volume variable. In particular, Dr. Neels presents "three sets of analyses," and "all three find volume variabilities that are much closer to one hundred percent, and often in excess of that level." Tr. 27/12828.

In attempting to argue otherwise, the Postal Service cites Dr. Neels' shape-level regressions of hours on TPH, but it conveniently ignores the key issue: Dr. Neels' criticism of TPH as a cost driver and as an inappropriate proxy for volume. See Postal Service Brief at V-24. When the variabilities resulting from Dr. Neels' shape-level regressions and Dr. Bozzo's own regressions are adjusted to take account of the lack of proportionality between TPH and volume, the results show variabilities close to or above 100%. Tr. 27/12832-39. Moreover, Dr. Neels' time series analysis also contradicts Dr. Bozzo's results. See Tr. 27/12843 ("The results strongly indicate that volume variabilities are greater than or equal to one"), 12839.

The Postal Service is able to argue otherwise only by changing Dr. Neels' analyses to make them conform more closely to that of Dr. Bozzo. It should be no surprise that if one uses Dr. Bozzo's data and his models, one of course obtains results that closely resemble Dr. Bozzo's results. But Dr. Bozzo's results are not the only "statistically admissible regression results" in the record. Postal Service Brief at V-25. Rather, the whole point of Dr. Neels' analysis is that Dr. Bozzo's results are at odds with those obtained when Dr. Bozzo's questionable assumptions are changed.

The Postal Service argues that "If the 100 percent volume-variability assumption were correct, there is no valid reason to suggest that the models would not show that result." Postal Service Brief at V-28. Again, that is of course true if an appropriate measure of volume is used in the model, if the data used is of good quality, and if the model is specified correctly and reflects the full impact of all factors which are adjusted in response to volume changes. The problem is that Dr. Bozzo's analysis does not meet these crucial tests.

The Postal Service also states that all relevant and significant variables should be included in regressions. Postal Service Brief at V-30 to V-31. Once again, that is of course true. However, at a minimum, the analyst must consider how a relevant variable changes in response to volume in order to capture the full effect of volume on costs.¹⁴

In arguing that FHP is not a proper measure of mail processing volumes, Postal Service Brief at V-32, the Postal Service once more completely sidesteps the primary issue: whether TPH varies proportionately with RPW volume. The "proportionality" assumption is key, as Postal Service witness Bradley testified in connection with his analysis of purchased transportation costs, Tr. 43/18388, and as the Postal Service later recognizes in its brief when dealing with the variability of purchased transportation

14. The Postal Service concedes that the "manual ratio" used by Dr. Bozzo "could be influenced by volume," but cites Dr. Bozzo's testimony that this "would be . . . an extremely short-run phenomenon." Postal Service Brief at V-31 n.5. Dr. Bozzo's suggestion that "technology changes . . . cause volumes to shift out of manual operations, but are not associated with a change in RPW volumes," *id.*, ignores the testimony in the record which establishes beyond doubt that decisions to shift to mechanization and automation are largely volume-driven. See UPS Brief at 22-23.

costs. Postal Service Brief at V-131 to V-132. Dr. Neels investigated the relationship between TPH/TPF and FHP in order to test the proportionality assumption, and he found that TPH and TPF come up short. Tr. 27/12802-09.

Similarly, in arguing that Dr. Bozzo's fixed effects estimator corrects for data recording errors, the Postal Service overlooks the rebuttal testimony of its own witness. Dr. Greene testified on cross-examination that data errors cannot be ignored if they are not constant over time. As he stated, if some managers give in to a temptation to alter data while others do not, "[I]t conceivably could create a problem." Tr. 46/22116.

The Postal Service's position that Dr. Bozzo's results are appropriate because he "holds capital input constant," Postal Service Brief at V-40 to V-41, only serves to illustrate the poor underpinnings of Dr. Bozzo's analysis. The record evidence indicates that capital does in fact vary over the course of the rate cycle. See UPS Brief at 22-24 (citing USPS-T-10 at 4-9, 10, 12-15, 20, 31-32, and Tr. 38/17293-94, 46/20475). Furthermore, merely because costs do not vary instantaneously does not mean that they are not volume variable. Again, the Postal Service's own arguments demonstrate that its analysis is ~~too~~ short run and merely shifts costs from the attributable category to the institutional category.¹⁵

The Postal Service's contention that serious data quality problems may be ignored, Postal Service Brief at V-44 to V-50, should be decisively rejected, as the

15. The Postal Service misrepresents the conclusions Dr. Neels reached in a nearly 20-year old paper on residential energy use in an apparent effort to create contradictions where none really exists. Postal Service Brief at V-38, V-42 to V-43. A careful review of that paper shows that it actually points out the weaknesses of the Postal Service's approach.

Commission did in Docket No. R97-1. R97 Decision at 1/63-92, ¶¶ 3001-3056. Those problems are not limited to manual operations. Tr. 27/12797-98, 46/22340 (SPBS data); 22342, 22343 (OCR data); 22344 (LSM data); 22345 (FSM data).¹⁶ More important, the question is not whether Dr. Bozzo eliminated the “vast majority of the apparently anomalous MODS data.” Postal Service Brief at V-47. The overall error rate sheds light on the reliability of the data set **as a whole**. The nature, frequency, and magnitude of the errors call into question the entire data set. As Dr. Neels testified, there is no assurance that the data actually used by Dr. Bozzo does not “contain other errors that are undetectable by the simple editing screens [Dr. Bozzo] uses.” Tr. 27/12798. See also *id.* at 12799-800.¹⁷

* * *

Try as it might, the Postal Service cannot rely on econometric slight-of-hand to overcome the fundamental flaws in its approach: seriously suspect data, reliance on a cost driver that is an inappropriate proxy for volume, and the failure to capture the full impact of volume on factors which the Postal Service erroneously argues are independent of volume.

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16. If that were the case, and if Dr. Bozzo’s analysis were otherwise appropriate -- which it is not -- the Commission could possibly accept the results for all pools but the manual pools while continuing to treat the costs in the manual cost pools as fully volume variable. Unfortunately, Dr. Bozzo’s analysis suffers from other serious shortcomings that preclude even this limited adoption of it.
 17. The Postal Service is wrong when it claims that non-random errors in TPH are “innocuous” and will not affect the results of the analysis; whether that is true or not depends on the nature of the error. Tr. 27/12800-02.

The Commission is in virtually the same position as it was in Docket No. R97-1. The evidence in the record does not justify abandonment of the Commission's long-held conclusion, based on logic, common sense, its expertise and knowledge of postal operations, and the corroborative data in Dr. Neels' testimony that mail processing labor costs are essentially fully volume variable.

**THE POSTAL SERVICE'S EXCUSES FOR NOT DISTRIBUTING
A PORTION OF THE DEDICATED AIR NETWORK PREMIUMS
TO PRIORITY MAIL SHOULD BE REJECTED.**

The Postal Service's arguments in support of loading the premium costs of its dedicated air networks on Express Mail alone are largely red herrings. For example, the Postal Service spent a great deal of time arguing that WNET and Eagle network operations require the use of jets rather than turboprops. Postal Service Brief at V-152 to V-153. That argument fails to address Dr. Neels' point that if the WNET had to carry only the 9% of its total volume that consists of Express Mail, and if the Eagle network had to carry only the 24% of its total volume that consists of Express Mail, the Postal Service could use "*smaller* aircraft." Tr. 32/16133-34. That is not the same as saying that turboprops may be used in place of jets.

Dr. Neels specifically testified that jets smaller than those now used on these networks could be used to handle the Express Mail volume that moves on them. Tr. 32/16133-34. In fact, the Postal Service used smaller jet aircraft on the WNET before it substituted larger B727-200s for the smaller DC-9s on August 27, 1999. Tr. 32/15999. But regardless of whether turboprops or smaller jets could be used, the point is that, as

Dr. Neels has testified, "the evidence suggests that the dedicated networks are sized for the combined volume of Priority Mail and Express Mail." Tr. 32/16001.

The Postal Service points out that the percentage of network volume represented by Express Mail remains much the same as it was in Docket No. R97-1, "when the Commission first allocated the premiums solely to Express Mail." Postal Service Brief at V-154 (citation omitted). But the Commission's decision to depart from its previously-established treatment -- under which the premium was distributed to Priority Mail as well as to Express Mail -- was unchallenged in that case. In fact, as pointed out in our initial brief, the Commission's decision was based essentially on "one unchallenged sentence from one Postal Service witness." UPS Brief at 29 (citation omitted). Far more telling is the fact that the volume of Express Mail moving on the Eagle network in Docket No. R90-1 was also much the same as it is today, and the Commission there rejected arguments that the premium should be distributed solely to Express Mail but instead concluded that Priority Mail should pay part of the premium. Tr. 43/18561; see R90 Decision at III-182 to III-193, ¶¶ 3692-3716. The Commission reaffirmed that decision in Docket No. R94-1, again in the face of arguments to the contrary. R94 Decision at III-50, ¶ 3166.

The Commission's conscious and deliberate decisions of a litigated issue in Docket Nos. R90-1 and R94-1 to distribute the premium to Priority Mail as well as to Express Mail stands in stark contrast to its four-sentence acquiescence in Docket No. R97-1 to the Postal Service's unchallenged assertion that the premium should be allocated only to Express Mail.

The Postal Service seems to think that current EVA incentives for Priority Mail and First Class Mail somehow militate against having Priority Mail pay a share of the network premium. Postal Service Brief at V-155. But those incentives say nothing about whether the networks have been configured solely to meet Express Mail's volume and service commitments. Nor does the fact that penalties for service failures are higher for Express Mail than for all other mail mean that the networks were not configured with Priority Mail in mind. The Postal Service cannot change the central fact that the capacity of both networks far exceeds anything that is remotely necessary to handle the small amounts of Express Mail that move on them merely by writing such clauses into its network contracts.

Finally, the Postal Service suggests that the low Express Mail volume shares on the networks "are annual averages, which can and do vary on a daily basis," and that the extra capacity on the networks "must be available to handle these shifts, some of which can be anticipated and some of which cannot." Postal Service Brief at V-154 (citations omitted). It is almost ludicrous to suggest that the Postal Service is paying for ten times the capacity of Express Mail's annual average volume on the WNET and four times the capacity of Express Mail's average annual volume on the Eagle network in order to handle daily fluctuations in Express Mail volume. The Postal Service has not provided one single piece of evidence to suggest that Express Mail volume fluctuates so much from day to day, or even from one time of the year to another (even the peak holiday season, when "the Postal Service operates a special Christmas network to handle the high volumes of expedited mail tendered during that time period," Tr. 32/15996).

It is clearly inequitable to impose the entire amount of the WNET and the Eagle network premium on a class of mail that represents only 9% and 24%, respectively, of the volume carried on those networks, and not to distribute any of the premium to another product which represents 54% and 47%, respectively, of the volume they handle. Tr. 32/15998. The Commission should remedy its mistaken reliance on the Postal Service's unchallenged and unsupported assertion in Docket No. R97-1 by distributing the network premium both to Priority Mail and to Express Mail in this case.

**THE COMMISSION SHOULD MODIFY THE POSTAL SERVICE'S
PARCEL POST COST AVOIDANCE CALCULATIONS.**

Again, we will not address every argument concerning the Postal Service's Parcel Post rate design made by the Postal Service and others in their briefs. Instead, we confine our comments to those instances where a point made by another party in its brief has not already been addressed in our initial brief, or where an argument made in the other briefs could be misleading.

1. The Postal Service and PSA attack Mr. Luciani's testimony that a modified mail processing cost model should be used in place of that used by Postal Service witness Eggleston to calculate DBMC avoided costs. Postal Service Brief at VII-114 to VII-115; PSA Brief at 26-28. Their argument is that Mr. Luciani's model is incomplete. See Postal Service Brief at VII-114.¹⁸

18. PSA argues that the model is missing the cross-dock operation at the origin SCF (PSA Brief at 26-27); interestingly, the Postal Service does not make this argument.

However, as the Postal Service recognizes, Mr. Luciani modified his model to take account of operations at such offices. The origin SCF operational data he used is used by the Postal Service itself to determine the non-machinable surcharge for inter-BMC and intra-BMC parcels. USPS-T-26 at 9; *id.*, Attachment A at 1, 7-12. While that data may not be perfect, there is no reason to believe that these estimates either overestimate or underestimate origin SCF costs. Moreover, while PSA asserts that the origin SCF data misses a cross-dock operation, the Postal Service deliberately excluded that operation when it set up its origin SCF mail flows both in this case and in Docket No. R97-1. PSA Brief at 26-27; USPS-T-26, Attachment A at 1, 7-12; Docket No. R97-1, USPS-T-9, Appendix V.

In short, the Postal Service would have the Commission adopt Ms. Eggleston's DBMC cost avoidance model knowing that there is a serious error in it. That should not be done. Instead, Mr. Luciani's reasonable adjustment should be made.

2. The Postal Service and Amazon.com argue that no Alaska Air costs should be allocated to the DSCF and DDU rate categories even though those rate categories are available in Alaska. Postal Service Brief at VII-116 to VII-117; Amazon Brief at 15. The fact that the DSCF and DDU rate categories did not exist in FY1998 and that test year costs have been extrapolated from 1998 costs does not mean that, as these parties argue, no test year Alaska Air costs should be allocated to the DSCF and DDU rate categories. Now that it is clear that the DSCF and DDU rate categories are in fact available in Alaska, they should be allocated a share of Alaska Air costs.

3. Amazon.com states that Mr. Luciani "refuses to adjust his estimation of Parcel Post's allocable [advertising] costs" to reflect the Postal Service's updated 1999

figures. Amazon Brief at 19. Amazon.com is just plain wrong; it focuses on Mr. Luciani's supplemental testimony that the Postal Service's arbitrary treatment of advertising costs should be rejected, but if it had looked at his numbers, it would have seen that his calculations using the FY1999 data use the Postal Service's FY1999 (arbitrarily reduced) advertising allocations.

CONCLUSION

The statutory ratemaking policies and the evidence in the record require that the Postal Service's proposed rates be modified. UPS has provided the Commission with analyses intended to assist the Commission to recommend rates that better reflect those policies and the evidence.

WHEREFORE, United Parcel Service respectfully requests that the Commission:

(1) Reject the Postal Service's proposal to reduce substantially the attribution of mail processing labor costs and instead reaffirm the Commission's well-established attribution of such costs, distributing them to the classes of mail on the basis of the MODS-based approach adopted by the Commission in the last case as modified by the Postal Service in this case;

(2) Mark up all of the costs attributable to each class of mail, including the volume variable and the specific fixed costs of each class;

(3) Revise the Postal Service's treatment of purchased transportation costs to (a) distribute the premium costs of its dedicated air networks to Priority Mail as well as to Express Mail, and (b) allocate the cost of empty space in purchased highway

transportation on a basis that better reflects what mail gives rise to the need for the total capacity purchased;

(4) Improve the distribution of attributable City Carrier elemental load costs to parcels and the attribution of advertising costs to Priority Mail, Parcel Post, and Express Mail;

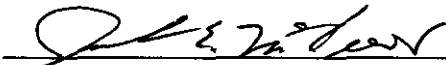
(5) Reject and correct the Postal Service's estimates of Parcel Post revenue, pieces, and weight, including (a) its ill-considered reliance on the hybrid "BRPW/DRPW" approach in place of the long-used DRPW method and (b) its improper treatment of OMAS and Alaska volumes and revenues;

(6) Adopt cost coverages for Priority Mail and for Parcel Post that are more consistent with the statutory goal of protecting captive customers rather than mailers with readily available alternatives;

(7) Correct the Postal Service's Parcel Post rate design errors; and

(8) Approve the Postal Service's proposed contingency allowance.

Respectfully submitted,




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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document by first class mail, postage prepaid, in accordance with Section 12 of the Commission's Rules of Practice.



John E. McKeever
Attorney for United Parcel Service

Dated: September 22, 2000
Philadelphia, Pa.

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